

**Office of
The City Attorney
City of San Diego**

**MEMORANDUM
MS 59**

(619) 236-6220

DATE: September 23, 2011

TO: Audit Committee

FROM: City Attorney

SUBJECT: City Attorney Process re Litigation Loss Contingencies

On September 12, 2011, the Audit Committee considered the City's fiscal year 2010 Comprehensive Annual Financial Report (CAFR). During that discussion, members of the Audit Committee requested that the City Attorney's office prepare a written description of the process by which litigation matters are disclosed in the CAFR. This memorandum describes the process of the City Attorney's office, the related but distinct process of the Disclosure Practices Working Group (DPWG), and addresses specific questions posed by the Committee.

The City Attorney's office does not determine which particular litigation matters are disclosed in the CAFR but does work with the City Comptroller's office and the City's outside auditors in the preparation of the CAFR note on litigation loss contingencies. The City Attorney's office provides to the City's outside auditor a description of all material litigation being handled by the City Attorney's office (and cases handled by outside counsel but overseen by the City Attorney). The City Comptroller requests and authorizes this disclosure in an audit inquiry letter. The audit inquiry letter specifies the fiscal year for which the information is being requested, the types of claims for which information is being sought and a materiality standard¹, which is expressed as the dollar amount of potential loss to the City from an adverse ruling.

Upon receipt of the audit inquiry letter, the City Attorney's office collects the requested information from the responsible attorneys and incorporates this information into a confidential attorney representation letter, which is sent directly to the outside auditor. The attorney representation letter, sometimes known as a FAS 5 letter², is used by the outside auditor and the Comptroller's office to determine what litigation loss contingencies must be disclosed in the notes to the financial statements.

¹ The materiality standard for inclusion in the attorney representation letter is substantially lower than that for inclusion in the CAFR.

² From Statement of Financial Accounting Standards No. 5, now known as Statement of Financial Accounting Standards Codification No. 450.

While the City Attorney's office is not involved in the determination of which specific matters are included in the CAFR, this Office understands that the process is fairly mechanical and is based on two specific pieces of information provided in the attorney representation letter regarding each case: the likelihood of an unfavorable outcome and the range of potential loss to the City. The likelihood of an unfavorable outcome is always expressed by the City Attorney's office as either remote, reasonably possible or probable. If the likelihood of an unfavorable outcome is remote (meaning the chance of a negative outcome is low) the case would not be disclosed. Similarly, if the likelihood of an unfavorable outcome is probable (meaning the chance of a negative outcome is high) the case would not be disclosed but the loss would be accrued in the financial statements. If the likelihood of an unfavorable outcome is reasonably possible (meaning more than remote but less than probable) *and* a case meets the CAFR materiality standard (potential loss in excess of \$2 million) it will be disclosed in the CAFR.

The DPWG also has a role with respect to the disclosure of litigation loss contingencies but this is separate and distinct from that of the City Attorney's office. In its review of the draft notes to the financial statements, DPWG often discusses litigation disclosures in the context of examining why certain litigation has been disclosed but other litigation has not. This is to ensure that litigation has not been excluded in error and that litigation that has been included is appropriately described.

In addition to questions about the City Attorney's process, the Committee raised specific questions about a case recently filed on behalf of certain City employees against the City and SDCERS regarding damages suffered as a result of the pricing corrections from previously purchased service credits (PSC Litigation). Specifically, Committee Member DeMaio asked why the PSC Litigation was not included as a litigation loss contingency but gains associated with the pricing corrections were factored into the City's pension liability. With respect to why the litigation was not included, the answer is that the PSC Litigation did not, as of the date of the CAFR, meet the threshold for inclusion in the notes to the financial statements, as described above. At the same time, the gains to the City, in the form of reducing the City's unfunded pension liability, resulting from the service credit pricing corrections were not contingent. The City prevailed in earlier service credit litigation (see CAFR note 12) and SDCERS is currently implementing the pricing corrections. As of the June 30, 2010 Actuarial Valuation, this had reduced the City's unfunded actuarial accrued liability by approximately \$50 million. While this amount may be adjusted in the future once the purchased service credit recovery process is completed, the City has realized actual gains from the correction process and that is reflected in the CAFR.

Committee Member DeMaio also asked generally about litigation involving pension and retiree healthcare obligations and the various negotiated changes to the pension and retiree healthcare benefits offered by the City. With respect to litigation, all such matters are handled in the CAFR as described above. Because no pension or retiree healthcare litigation met the standards for inclusion in the notes to the financial statements, none were disclosed.

Negotiated changes to the City's pension and retiree healthcare benefits are handled somewhat differently. Pension and retiree healthcare (other post employment benefits (OPEB) in the

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CAFR) obligations are disclosed in notes 12 and 13, respectively. The note disclosures are generally based on the actuarial valuations of each benefit plan. The pending changes to those benefits are disclosed in note 21 of the CAFR, which discusses events occurring after the end of the fiscal year in question (June 30, 2010) which could have a material impact on the information otherwise presented in the financial statements. Because the negotiated pension and retiree healthcare changes are material in a qualitative sense, they are disclosed.

JAN I. GOLDSMITH, City Attorney

By

A handwritten signature in black ink, appearing to read "Brant C. Will".

Brant C. Will
Deputy City Attorney

BCW:jdf